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TREASURY FOR OASIA/ZELIKOW AND WISNER
TREASURY PLEASE PASS TO OCC/AMCMAHON
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GOVERNORS, AND SAN FRANCISCO FRB/TERESA CURRAN

E.O. 12958: N/A

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SUBJECT: Taiwan Economic Review for October 2004

1. This cable summarizes selected economic events in Taiwan in October 2004. Below is a table of contents:

- China's Interest Rate Hike
- Central Government Budget
- China Airlines Privatization
- Cross-Strait Economic Normalization
- Problem Financial Institutions

Effect of China's Interest Rate Hike

2. In late October 2004, the People's Bank of China (PBC), China's central bank, raised interest rates for the first time in nine years. Taiwan's exports rely heavily on production lines based in China, and Taiwan companies will face some increased operating costs brought on by higher interest rates. Taiwan economists expect that higher interest rates will dampen China's real estate sector and cut into Taiwan's exports of construction materials such as iron and steel. However, this will have little impact on Taiwan's China-based manufacturing, since most of its production is for export to the U.S. and other developed markets.

Taiwan's Central Government Budget

3. According to the proposed 2005 Taiwan government budget, income taxes remain the major source of Taiwan's central government revenue. However, Taiwan's Executive Yuan expects proceeds from sales of public enterprise equity shares to double this year. It hopes to use these proceeds to reduce the growing budget deficit. Public debt is nearly NTD 3.67 billion (USD 107.9 billion) or 35.7 percent of Taiwan's GNP. The extent to which equity sales are able to cut public debt will depend on how much can actually be sold in the face of strong opposition from labor groups and some legislators.

Privatization Plans for CAL Changed

4. Taiwan's Ministry of Transportation and Communications (MOTC) stepped back from plans to fully privatize China Airlines (CAL), which is currently 69 percent state-owned, by the end of 2005. In a recent speech, MOTC Minister Lin Lin-san said the government needed to keep a controlling stake in the airline, though not more than 50 percent. He said that like many other nations, Taiwan should have a "national" airline that can demonstrate Taiwan's sovereignty to other countries. CAL's recent profit report for 2004 may have influenced the change in policy. On October 20, CAL predicted its 2004 profit would be NTD 90 billion (USD 2.7 billion).

Cross-Strait Investment Festival

5. The Taiwan Ministry of Economic Affairs, Straits Exchange Foundation, and Mainland Affairs Committee (MAC) hosted some 300 participants at their 2004 mid-autumn festival event for Taiwan investors in China on October 3-4 in Taoyuan. President Chen, Vice President Lu, Premier Yu, and MAC Chairman Joseph Wu all took part in the event. In his public remarks, Premier Yu said that Taiwan would continue to promote cross-strait economic and trade normalization, including expanding China's permitted commercial activities in Taiwan, liberalizing tourism and

professional exchanges, expanding imports, and initiating consultations on cross-Strait direct transportation. MAC Chairman Wu reiterated Taiwan's willingness to discuss charter flight service with China for Taiwan investors' returning to Taiwan for the 2005 Chinese New Year holidays.

16. Separately, the twelfth annual Taiwan, PRC, and Hong Kong insurance cooperation conference took place in Taipei from October 25 to 26. In recent years, Taiwan's Cathay Life, Taiwan Life, and Min Tai (Non-life) have all set up offices in the PRC. This year the level of the PRC's government representation at the conference was raised to a division head insurance supervisory official.

Problem Financial Institutions

17. After more than two years of financial reform, Taiwan's smaller financial institutions still have serious, although sometimes hidden, problems. The Agricultural Financial Bureau reported to the Legislative Yuan in mid-October 2004 that only three Farmers' Associations credit departments had negative net worth. However, a legislator revealed an internal Agricultural Financial Bureau report that concluded that 92 out of 279 Farmers' Association credit departments had negative net worth. The internal report also indicated that 99 Farmers' Association's credit departments reported non-performing loan ratios above 15%. The discrepancy was the result of using two different ways to calculate non-performing loans. The stricter method, which uses the internationally accepted definition of non-performing loans as no payment of interest or principle for at least three months, indicates more of the credit departments have negative net worth.

PAAL